

Senate Finance Committee and House Ways & Means Committee Hearing
“Tax Reform and the Tax Treatment of Debt and Equity”
Wednesday, July 13, 2011
Questions for Dr. Mihir A. Desai

Question from Senator Hatch:

1. Although the debt levels of corporations have roughly stayed the same over the decades, we see that both household debt and government debt have gone up considerably in recent years. I’m interested in what the relationship, if any, is between household debt and government debt.

One way to think of government debt is that it is simply deferred taxes. High government debt today simply means high taxes tomorrow. Thus, assuming that households behave in a rational fashion, one might think that high government debt, such as we have had, would lead households to save more so as to pay for the high government taxes down the road. But, despite high levels of government debt, we don’t see households in fact saving much -- to the contrary, they are going ever deeper into debt.

Do you have some thoughts on that? Does it surprise you at all that simultaneously household debt and government debt would both go up significantly? Had the government not run the significant deficits that it has in recent years, do you think it likely that households would have saved even less – that is, would household debt have been even more?

Optimizing households could have saved to offset the rising government debt but it is hard to imagine that this is what has happened. More generally, this notion of Ricardian Equivalence, as it is known, does not have a great deal of empirical support. My sense is that these are two distinctive phenomena. Rising fiscal problems reflect structural issues in our entitlement programs, expansion of defense and non-defense expenditures and the failure to raise taxes in parallel. Separately, debt-financed consumption by Americans reflects changed preferences for current consumption and policies that don’t favor saving. So, I view these phenomena as distinct.

Questions from Chairman Baucus:

1. Current tax law generally provides an incentive for corporations to capitalize with debt rather than equity since corporations can deduct interest but cannot deduct dividends. This tax benefit may be offset somewhat by the lower tax rates on dividends and capital gains compared to interest income.

There has been considerable commentary suggesting that as part of tax reform, tax rates should be reduced and the base should be broadened. Others believe the current 15 percent tax rate on dividends and capital gains could be increased. Let me ask each of you:

- a) What do you believe have been the effects of the current lower rate for dividends? Has it resulted in more equity financing and less debt financing by corporations?

The lower rate for dividends has been shown to have stimulated a rise in dividend payments. I think this has been the primary effect of the lower rate of dividends. At the same time, it has likely also lowered the cost of equity financing and, therefore, changed the relative preference for equity.

- b) Are there some industries that you think are especially affected by the different tax treatment of debt and equity? How?

Industries which use the most leverage are unsurprisingly the most affected. Typically, industries where business risk is low are most able to handle financial leverage. So, industries, with low business risk (eg. utilities) and those with the steadiest cash flows typically have the most leverage. Those industries are the most affected. The tax shields from taking on debt are thought to be significant for these firms as their businesses are simpler, there is more financial engineering on the right hand side of the balance sheet.

- c) Are there some industries that rely more or less on debt than is good for the economy? If so, how much does it relate to the tax code and is it a major problem?

Industries and organizational forms (such as leveraged buyouts) that rely on leverage do benefit from the tax code's treatment. The costs to the economy are twofold – first, there are revenue losses. Second, there is the possibility of excessive leverage which has spillover effects. As I discussed in my written testimony, there is little evidence that the economy as a whole is overlevered or that the financial crisis was caused by the tax code.

- d) Do you believe that the existing tax advantage for the use of debt by corporations is a problem that should be addressed as part of tax reform? If so, how would you suggest we address this tax bias? How would your proposed solution impact revenues?

In my written testimony, I elaborate on why I believe that excessive leverage is not one of the most important problems in the corporate tax today. Instead, I propose a comprehensive business income tax or, less ambitiously, a rate cut and a move to territoriality financed by a tax on non-C corporation business income and an alignment of book and tax income.

2. The Tax Code does not provide a definition of debt or equity, but rather a determination is made on the facts and circumstances of the interest in the entity. The lack of a uniform definition allows taxpayers to essentially choose the most beneficial tax treatment by structuring their deals as loans or equity.

- a) Do you think this is a problem? *Yes. My written testimony elaborates on the abilities of financial engineers to game these distinctions.*

- b) If yes, should a uniform definition be part of the Tax Code or regulations? What other ways could we provide a uniform and certain definition so that similar economic outcomes are taxed in the same way?

The clearest path toward that would be a move toward comprehensive business income tax.

3. Would it be an improvement in our law if all corporations were subject to a statutory limit on the deductibility of interest, based on a ratio such as net interest expense to adjusted taxable income?

No. I think, as elaborate in my written testimony, that such regulations do not address a major problem in the corporate tax and such regulations are complicated by many realities on the ground that are non-trivial.

If so, should the limit for a given corporation be determined by looking at the relevant ratio for the worldwide affiliated group of corporations which includes the taxpayer (disregarding intra-group loans)?